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C O N F I D E N T I A L SECTION 01 OF 03 CARACAS 001003

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E.O. 12958: DECL: 05/22/2017
TAGS: ECON EFIN
SUBJECT: VULNERABILITIES OF THE VENEZUELAN ECONOMY

REF: A. CARACAS 930
¶B. CARACAS 959

Classified By: Economic Counselor Andrew N. Bowen for reasons 1.4(b), (
d).

¶1. Summary: (C) Although Venezuela has a strong external position, we continue to maintain that the economy is very vulnerable in the next 12-30 months due to increasing economic distortions (caused by increasing statist/retrograde economic policies) that will eventually lead to an economic/financial crisis. Such a crisis would probably be sparked by declines in oil prices and/or production to the point that the BRV,s massive government spending cannot be sustained. End Summary.

THE SCENE

¶2. (C) While there are many variables to take into account, we assume in our base scenario that the Venezuelan oil basket stays above USD 50/barrel for the medium term, and Chavez remains incapable of fiscal discipline and increasingly rejects market-oriented policies. Political consolidation remains at the top of Chavez' agenda for the next 14 or so months, so we do not expect that he will intentionally cross any economic redlines -- but the private sector will continue to shrink, and there will probably be a surprise or two -- unless frontally challenged.

¶3. (SBU) The oil windfall which has permitted massive government spending and a consumption boom (despite any substantial private investment) has resulted in real growth rates of over 10 percent for the past three years. Nonetheless, the cracks are already beginning to show. Inflation remains the highest in the hemisphere (19.4 percent for the past 12 months) and monetary policy appears increasingly incapable of reining in liquidity (up 50 percent in the last 12 months) driven by government expenditures and currency controls (reftel B). The Venezuelan bolivar has steadily fallen in value over the past 12 months in the parallel market, which now values the bolivar at Bs. 4200 to the dollar (the official exchange rate is Bs. 2150 to the dollar).

¶4. (SBU) The 34 percent drop in foreign exchange reserves during the first trimester of 2007 is attributable to BRV policies, including transferring reserves to the National

Development Fund (FONDEN), setting aside funds for the "nationalization" of electrical and telecommunications companies, increased foreign exchange approvals from the currency control authority CADIVI, and the purchase of bolivar proceeds from PDVSA's USD 7.5 billion bond issuance in April (reftel B).

¶5. (SBU) Venezuela still has over USD 24 billion in official reserves, and estimates are that it has upwards of USD 39 billion in off-balance sheet reserves of varying liquidity, including FONDEN (USD 15.2 billion in dollars), BANDES (USD 10.4 billion, mostly in dollars), PDVSA accounts at the Central Bank (USD 2.2 billion in dollars), and in government funds deposited in the banking sector (USD 11.5 billion in bolivars). In the BRV, government funds are fungible, and this money could be redirected to defend the currency or prop up spending during a crisis. Venezuela's sovereign foreign debt remains manageable (around 16 percent of GDP). Venezuela's debt stock, however, is increasing, both internally and externally, as the BRV tries to maintain its incredibly high spending levels while oil production and prices stagnate or trend downwards and increasing inefficiencies and corruption take their toll on government performance (reftel A).

¶6. (SBU) While the overvalued fixed exchange rate negatively impacts domestic producers (by subsidizing imports) and the currency control regime imposes many inefficiencies on the Venezuelan economy, post does not think the BRV is likely to eliminate these controls in the near to medium term. If currency controls were eliminated, capital flight could rapidly drain the country's reserves. While the BRV may be forced to devalue in the near term to increase domestic spending and bring the official and parallel rates closer together, it is loath to do so for fear of stoking inflation

as most prices in Venezuela are referenced to the dollar due to Venezuela's heavy reliance on imports and exports.

¶7. (C) The BRV and PDVSA are probably spending more than they are making, but the extent of the deficit spending is hard to calculate. We believe PDVSA is currently producing 2.1-2.3 mbd of oil. It has repeatedly stated its intention to make up for expiring OPEC cuts, but it is unlikely that today's PDVSA is capable of producing much more than 2.4 mbd. Moreover, despite grandiose investment plans, few analysts expect a significant increase in output in the near to medium term.

CONTAGION?

¶8. (C) We believe that should a financial crisis occur here it would have a limited effect on the region -- thus far investors have clearly distinguished the risks posed by Venezuela from the rest of Latin America. Venezuela's risk indicator has risen in recent weeks, especially following Chavez' announcement that he intended to withdraw from the IMF and World Bank, but this upward trend has not occurred in neighboring countries.

¶9. (C) Venezuela is a major importer (over 60 percent of its food is imported) and a financial crisis could negatively impact its major trading partners (by hurting their export sectors) and aid recipients, including Colombia, Cuba, Bolivia, Ecuador, Brazil (less so given its size) and Argentina. Barring massive civil unrest, it is unlikely that a financial crisis would affect oil exports to the United States; if anything it would make Venezuela more reliant on maintaining oil shipments to the United States as its main source of hard currency. Estimates are that up to 90 percent of Venezuela's hard currency (dollar) revenues come from oil sales, mostly to the United States, and in the first quarter of 2007, over 75 percent of petrodollars went to fund

imports, (which grew by 47 percent during this time period, following record growth in 2005 and 2006). Venezuela today is even more heavily reliant on oil exports, with its percentage of total exports having grown from 69 percent in 1998 to 90 percent in 2006 (in part due to the increase in the price of oil).

¶10. (SBU) CADIVI has been authorizing over USD 147 million in bolivar for dollar currency exchanges daily (calendar day) thus far in the month of May, almost double the daily average for 2006. Post estimates that Venezuela had an average of USD 171 million daily in dollar income from oil sales, meaning that right now there is precious little room to fund government expenditures or build back reserves.

OUTLINES OF A CRISIS

¶11. (C) Clearly the BRV is facing an unsustainable economic situation and a correction will occur, possibly within the next 12-30 months. That correction could reach crisis proportions. If such a crisis were to occur, it could play out as follows: the BRV runs out of money, either because it has spent too much, oil prices fall, or production falls (probably some combination of the three). Barring radical actions by the government (nationalizing the banks, declaring private property illegal, etc) or some unforeseen political event, post expects one possible scenario for a financial crisis could be provoked by declining government expenditures leading to a drop in liquidity.

¶12. (C) Under such a scenario, the heavily leveraged financial sector would face large scale defaults as bank clients dependent on government spending and cheap money cannot pay their bills as the government spigot runs dry. At the same time, the government may be forced to devalue to recoup spending power. Because the economy is effectively dollarized (90 percent of its foreign exchange income and at least 60 percent of its imports are in dollars), this would result in hyper inflation. Given the interdependency between many banks, increasing defaults coupled with devaluation could lead to a banking crisis, which would probably result in heavy handed and poorly executed government intervention. Conversely, Chavez could view such a scenario as a

pretext/opportunity to take over the banks. For many analysts, bankers, and businessmen here, the question of a financial meltdown or other economic crisis remains more a question of when than if.

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